



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503



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February 19, 1988

MEMORANDUM FOR CABINET OFFICERS AND AGENCY HEADS

FROM: Joseph R. Wright, Jr.
Deputy Director, OMB and Chairman
Federal Credit Policy Working Group, EPC

SUBJECT: Revised Loan Asset Sale Guidelines

Attached is a copy of the revised Loan Asset Sale guidelines developed by the Federal Credit Policy Working Group. These guidelines, which were previously transmitted on July 8, 1986, have been revised to reflect experience gained during the highly successful FY 1987 asset sales and prepayment programs. Let me give you some results.

Public sales of loan assets from three portfolios were successfully concluded during 1987, yielding \$3.1 billion in total proceeds:

- o 6,442 community development loans with a face value of \$1.9 billion from FmHA's Rural Development Insurance Fund (RDIF);
- o 141,352 rural housing loans with a face value of \$3.0 billion from the FmHA's Rural Housing Fund (RHIF); and
- o 324 loans with a face value of \$237 million from the Department of Education's College Housing and Academic Facilities Loans.

The non-recourse sales were structured so as to create high quality, taxable, investment grade securities. All three issues received Triple-A ratings from national rating agencies.

Although the guidelines focus on many technical, "how to", aspects of sales, our goal is to reform all aspects of credit management. We need the private sector review of our portfolios for sale while obtaining recommendations for management improvements for a very good reason -- we have a significant problem.

- o Annual delinquencies continue to go up. From 1981 to 1987, non-tax delinquent debt increased from \$12 billion to \$32 billion; \$12 billion of this \$20 billion increase occurred in agriculture and education.

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- o Meanwhile, the amount of direct loans the Federal Government has to service continues to expand from \$185 billion in 1981 to over \$234 billion in 1987.

The loan asset sale pilot program has been a partnership of the best aspects of the private sector with the Federal sector to improve credit management. We have the same need for up-to-date billing practices, complete loan file documentation, and effective management reporting systems. If the private sector has a more efficient, more economical way of doing business, we must take advantage of their know-how. These changes in our procedures can have an enormous impact toward improving credit management of the Federal portfolio of over \$740 billion.

I appreciate the eagerness and enthusiasm you and your staffs exhibited for the FY 1987 sales. Let's keep up the effort in 1988 and make a lasting contribution to improved credit management.

Attachment

LOAN ASSET SALES GUIDELINES

February 9, 1988

I. Introduction

The following guidelines for the sale of loan assets and prepayments have been established and approved by the Federal Credit Policy Working Group. The guidelines are designed to insure that agencies will meet the objectives of the loan asset sale program which have been derived from the Administration's stated priority to reform Federal credit. These objectives are set forth as follows:

- o reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;
- o provide an incentive for agencies to improve loan origination and documentation;
- o determine the actual subsidy of a Federal credit program; and
- o increase unified budget offsetting collections in the year of sale.

II. Guidelines for Loan Asset Sales

The following guidelines shall be adhered to by each agency in its approach to, and implementation of, all loan asset sales. However, the Federal Credit Policy Working Group realizes that there are or will be occasions for which changes to the guidelines will be necessary. Agencies are encouraged to bring problems to the Working Group for discussion. The guidelines have been amended to reflect modifications already authorized by the Working Group, and will be modified periodically in the future to reflect additional changes.

- A. Loan asset sales shall be made without future recourse to the Federal Government. For the purposes of these guidelines, recourse includes any Federal guarantee of principal or interest payments; agreements to repurchase loans or to replace delinquent loans with current loans; warranties as to collateral value; and other agreements entailing continued Federal involvement that could create contingent liability. Recourse does not include: representation and warranty obligations in accordance with Guideline B; changes in internal agency policy or regulations needed to satisfy the agency's legal obligations to borrowers;

arrangements made by the purchaser of the loans to provide for credit enhancement measures (such as overcollateralization, reserve funds or insurance) that do not impose contingent liability on the agency or the government; or retention by the Federal Government of a junior security representing a residual interest in the income produced by the loans after the sale. Agencies planning to retain a junior interest for more than 18 months or for an indefinite period must submit to OMB a plan for disposition.

- B. If necessary, agencies may include in a loan sale agreement representations and warranties to the purchaser of loan assets concerning matters of fact and law, such as the characteristics of loans, the agency's authority to sell loans, and the legal enforceability of loans and security interests. Agencies may not warrant as to the future credit-worthiness of borrowers. The duration of warranty periods will be based on reasonable time periods for verification and will be determined on a case-by-case basis. The remedy for a breach of warranty may include substitution of an alternative loan not initially included in the sale pool or cash payment by an agency up to the value of the defective loan. Each agency is responsible for ensuring that it has the resources needed to satisfy warranty obligations. Loan sale agreements incorporating warranties shall be signed by an agency official of appropriate rank and shall name the individual agency as the warrantor. The text of warranties should be reviewed by OMB and Treasury.
- C. Loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to full Federal income tax. This does not preclude sales of securities representing pooled loans or whole loans to tax-exempt investors for portfolio or trading accounts in the normal course of business, but is meant to preclude purchases by such investors from the proceeds of tax-exempt borrowings made for that purpose. Further, the financing of prepayments of loans shall be on a taxable basis; that is, borrowers should not issue tax-exempt bonds to prepay their outstanding loan balances.
- D. Agencies should seek to contract out the servicing of loan assets prior to sale. If for valid reasons agencies are not able to do so before sale, collection and servicing shall be transferred to the purchaser with the sale of a loan asset.

- E. Agencies shall sell loans and prepare to sell loans in the amounts stated in the budget for FY 1988 and FY 1989. Agencies shall sell newly issued loans and seasoned loans from their portfolios after approval of their sale plan.
- F. Where appropriate, each agency shall choose, through a competitive process, professional financial consultant to provide expertise on its loan asset sale program. Consultants will not be permitted to purchase loans from programs on which they are advising.
- G. Loan asset sales may be conducted on a competitive bid or negotiated basis. In the latter case, the invitation to negotiate should be disseminated widely, and negotiations conducted as competitively as possible.
- H. In limited circumstances where the borrower is not an individual, agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price; borrowers who are not current on their principal and interest payments shall not be allowed to purchase their loans.
- I. Loan asset sales shall be sufficiently large to assure market interest. This is particularly important when developing markets for new types of securitized loans. In such cases, we would expect sales to be over \$100 million. Other details, including timing of sales, the composition and size of loan pools, and other marketing issues, shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.
- J. Agencies may sell loan assets held by the FFB.
- K. Agencies should not sell loan assets directly to Government-Sponsored Enterprises or to entities acting on their behalf for their own account.
- L. To the extent possible, newly made loans should be sold on a regular basis within six months of when the loan was closed. It is recommended that when newly made loans are scheduled for sale, agencies arrange for private servicing from the beginning. All proceeds from the sale of newly made loans will flow into the Treasury General Fund, absent legislation to the contrary.

- M. In competitive bid situations agencies should be prepared to analyze bids for minimum price acceptability against an established valuation methodology. It is not likely that there will be good reason to disclose the methodology or price floors to bidders. Any such minimum price valuation methodology should be reviewed by OMB and Treasury.